Our View in April

5 April 2022

VP BANK

Recession worries on the rise

Rising prices, new supply problems and a war in Ukraine. No wonder confidence among companies and consumers is sinking rapidly. The risks of recession are increasing, the warning lights have jumped to red. This speaks for a defensive portfolio orientation.

Russia and Ukraine both have only a small share of the world economy in their own right. As terrible as the war is and as much as it calls into question security policy since the fall of the Iron Curtain, the direct economic consequences would hardly be worth mentioning. But, and this is a big "but": the indirect effects are huge. It starts with energy prices, goes on to small but important elements in the industrial supply chains and ends with the agricultural market.

The price of a barrel of crude oil is still higher than before the Russian invasion and significantly higher than a year ago. This is fuelling the already high inflation in the short term. Yet consumers are already reacting to the drastic increase in inflation. Both in the USA and in Europe, consumer sentiment has deteriorated significantly. The main reason for this is a worsening assessment of both the economic situation and the consumer's own financial situation. As a result, private consumption as a pillar of the economy is likely to weaken for the time being.

But the fact that a recession is now looming is due to the companies. Their assessment of the economic outlook is also much worse. Higher commodity prices are squeezing margins and supply shortages are getting bigger, not smaller. This reduces the willingness to invest, which is so important for the economic cycle.

Due to the recession risk, we are confirming our defensive stance in the equity bucket of the portfolio. In addition, we are reducing the strong underweight in government bonds and close the position in Chinese bonds.

Dr. Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **Defensive stance**
- Prospect of higher returns from **insurance-linked securities**
- **Valuation** of Japanese and emerging market equities

- Increased risk for **European equities**
- High valuation of **US equities**
- **Interest rates still low** despite rise

Money market	● ● ● ● ○
Bonds	● ● ○ ○ ○
• Government Bonds	● ● ○ ○ ○
• Corporate Bonds	● ● ● ○ ○
• USD Bonds	● ● ● ○ ○
• Emerging Markets	● ● ● ○ ○
Equities	● ● ○ ○ ○
• Switzerland	● ● ● ○ ○
• Europe	● ● ○ ○ ○
• USA	● ● ○ ○ ○
• Japan	● ● ● ● ○
• Emerging Markets	● ● ● ● ○
• World and Themes	● ● ● ○ ○
Alternative Assets	● ● ● ● ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ● ○
• Convertible Bonds	● ● ● ○ ○
• Gold	● ● ● ○ ○

● ● ● ● ● strong overweight
● ● ● ○ ○ neutral
● ○ ○ ○ ○ strong underweight

Base: mandate CHF balanced

Our View on the **Economy**

- **Savings** of households and **full order books** of businesses mitigate the economic consequences of the war in Ukraine
- Switch to **renewable energy** in Europe will be accelerated, opening up potential for growth

- The war in Ukraine is intensifying **supply-chain issues**
- **High energy prices** dampen global growth
- **Omikron variant** of the coronavirus triggering lockdowns in China with negative consequences on product flow

Rising slowdown risk

Recession risks have risen markedly recently. This is particularly true in Europe. Companies are more pessimistic about the future business. Higher energy costs and supply bottlenecks going from bad to worse with the war in Ukraine are dampening the economic outlook. The automobile industry lacks wiring harnesses that have been produced in Ukraine. Likewise, the flow of materials from Asia is slowing due to new corona lockdowns in China. Central banks are not expected to provide support, given high inflation rates. Instead, the monetary tightening will continue. Increased interest rates are already negatively impacting the construction industry. Difficult quarters lie ahead.

Our View on **Monetary policy**

- **ECB** is keeping all the options open
- **Swiss National Bank** is expected to move after the European Central Bank will budge

- **Fed** becomes more aggressive by the week
- **Balance sheet reduction** by the Fed is an additional risk
- **ECB** risks not containing inflation in time if monetary policy is too loose

A difficult task for the ECB

The Federal Reserve is becoming more aggressive in its anti-inflation stance by the week. Similarly, in the dollar-money markets, 275 basis points of interest rate hikes have been priced in over the next two years (Fed Funds target range now: 0.25 to 0.5 %). At the same time, US central bankers will begin the balance sheet reduction. The Fed is picking up the liquidity that has been so freely distributed in recent years.

The European Central Bank (ECB) also recently toughened its tone. The end of all purchases of securities at the third quarter is expected even in a sharp economic downturn. A rate hike this year has also become more likely, according to recent speeches by ECB officials. In Switzerland, the SNB is waiting. But the the pressure is mounting to end the negative interest rate phase.

Our View on **Government Bonds**

●●○○○
underweight

- **Economic uncertainty** dampens the potential for a significant rise in yields at the long end of the yield curve
- **Money market** expectations price in a US interest rate cut in 2024

- **Fed is** soon **reducing its holdings of securities**. Bonds are losing support
- The ECB is also preparing **the end of government bond purchases**

Yield increase slowed down temporarily

Major central banks' changing course is triggering further changes in the interest rate universe. In the US, the flattening trend of the yield curve is continuing. The yields on two-year bonds increased more sharply than those of the ten-year-olds. The Fed's aggressive rhetoric suggests that interest rates will be raised more rapidly than previously expected. This simultaneously increases economic risks and dampens the potential for a yield increase at the long end of the yield curve. We reckon with the Fed's aggressive approach and the consequent increase in medium-term recession risks, with limited potential for yield increases at the long end of the yield curve. The more likely a rate hike by the European Central Bank (ECB) this year will become, the more noticeable the two-year euro government bonds will respond with price losses. This would also imply a flattening of the euro interest rate curve.

Our View on **Corporate Bonds**

neutral

- **Positive outlook** for earnings
- Hope of **agreement** in Ukraine helps stabilize energy prices

- Situation in **energy markets** still fragile - **escalation** not excluded
- Some central banks are still cautious about **fighting inflation**
- **Price increases** are broadening, risk of a wage-price-spiral rising

Volcker moment 2.0?

The second oil shock in 1979 was characterised by the Iranian revolution. Oil exports fell by 7% of world production. At the same time, there was strong demand. The resulting stagflation was fought by then-US Federal Reserve Chairman Paul Volcker with policy rates of up to 19%. With a severe recession, this cycle was broken. Another parallel today is the performance in bond markets. We are currently experiencing the highest quarterly losses since then. Although US corporate bond yields have risen from 2.3% to 3.7% since the start of the year, they are being overshadowed by the current inflation rate of 7.9%. The central bank, which has been forced to move, is likely to accelerate interest-rate hikes. Only when inflation rates come back significantly will corporate bonds become more attractive again.

Our View on **Equities**

underweight

- **Attractive fundamental valuations** in Europe and emerging economies
- **Fiscal support** helps mitigate the negative cost of the war in Ukraine

- Significantly increased **forecasting uncertainty** due to non-significant second- and third-round effects (including supply shortages, high energy and commodity prices)
- Russia's **war against Ukraine** is not over and consequences are not yet foreseeable

Seeking orientation

The first shock caused by rising energy and commodity prices and additional stress in the supply and production chains in manufacturing was followed by a first recovery. It is fuelled by hopes of an early end to the war in Ukraine and by the continuing solid development of earnings. However, it will not be possible for Europe and other countries affected to replace all imports of energy and raw materials from Russia with other suppliers in just a few quarters. There is simply a lack of production, processing and transport capacity. In addition, the industry's urgent focus on environmental sustainability requires further funding. The pressure on profit margins is rising, with the new economic reality only being felt with delay.

Our View on **Equities USA**

underweight

- Support for sales and profits in the **energy, agricultural and defense industries**
- **Small immediate impact** due to war in Ukraine

- Higher **commodity prices and rising wages** squeeze profit margins
- **Fundamental valuation** prices in the best outcome for stock markets

Deceiving Performance

The US stock market has performed better than the global benchmark since the war in Ukraine began. Market participants expect the US to be significantly less affected by negative effects (including inflationary pressure and supply chain disruptions) than other regions. In addition, it can be expected that recent developments will even boost certain sectors such as agricultural, energy and defense. The increased forecasting uncertainty, increased bond yields, and continued historically high valuations are leading to a low in the risk premium for investors. While the strategic underweight in US equities remains in place, price swings open opportunities in individual stocks. However, only companies with stable cash flows and high pricing power are recommended. Defensive investment should be preferred.

Our View on **Alternative Investment - ILS**

overweight

- **Not affected** by the war in Ukraine
- Benefits from **rising money market rates**
- **Independent of financial markets**

- **Natural disasters that are larger than modeled** can lead to loss of performance at any time
- **Inflation** lowers real returns

Higher yields

The war in Ukraine has fuelled financial-market volatility. Rising energy prices and additional disrupted supply chains are the reasons. Although hopes for a diplomatic solution have recently increased, the situation may escalate at any time. At the same time, central banks are now taking decisive action against inflation.

Virtually all asset classes are negatively affected by these developments. Insurance-linked securities are a major exception. They have been able to return 4.7% over the last 12 months, which is almost exactly the same as in previous years. As insurance funds are invested in the money market, they also benefit from rising interest rates. The return of investment alternatives is also likely to cause insurance premiums to rise further. All in all, returns tend to be higher in the future than in the past.

Our View on **Currencies**

- The **euro** has some catching up to do compared to the dollar and the Swiss franc
- **High-beta currencies** can increase in the run-up to a de-escalation of the war in Ukraine, especially the SEK

- **Russian ruble remains battered**
- **Emerging market currencies' recovery potential** remains limited in view of inflation risks

Euro with catch-up potential

At first glance, little seems in favour of the euro. The war on the European continent increases the economic risks considerably. At the same time, given the higher inflation rates, the ECB remains relatively relaxed, which also speaks for no significant appreciation of the euro. However, the return of euro interest rates to positive levels is expected to result in a disproportionate increase in capital inflows. Moreover, speculative investors have sold USD futures. The latter is a reliable counter-indicator that speaks for a weaker US dollar. For this reason, we stick to our view and expect higher EUR/USD prices in the coming weeks.

Authors and disclaimer

Authors:

Dr. Felix Brill, Dr. Thomas Gitzel, Harald Brandl, Bernhard Allgäuer

Important legal information

This documentation was prepared by VP Bank AG (hereinafter the bank) and distributed by the companies of VP Bank Group. This documentation does not constitute an offer or an invitation to purchase or sell financial instruments. The recommendations, estimates and statements contained therein reflect the personal views of the relevant analyst of VP Bank AG at the time of the date stated in the documentation and may be changed at any time without prior notice. The documentation is based on information that is considered reliable. This documentation and the assessments or assessments made therein are prepared with the utmost care, but their accuracy, completeness and accuracy cannot be guaranteed or guaranteed. In particular, the information contained in this documentation may not include all the essential information on the financial instruments covered or their issuers.

For further important information on the risks associated with the financial instruments in this documentation, on the proprietary business of VP Bank Group or on the management of conflicts of interest in relation to these financial instruments, and on the distribution of this documentation, see http://www.vpbank.com/legal_notice